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RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RHEHNSC/WHITE HOUSE NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHCN/AMCONSUL CHENGDU 0545
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RUEHKO/AMEMBASSY TOKYO 0108
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C O N F I D E N T I A L SECTION 01 OF 03 SHANGHAI 000211

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STATE FOR EAP/CM, EB AND E
STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SF FRB
FOR CURRAN/LUNG; NY FRB FOR CLARK/CRYSTAL/MOSELEY
TREASURY FOR ADAMS, AND OASIA - DOHNER, HAARSAGER, CUSHMAN
USDOC FOR ITA KASOFF, MELCHER, MCQUEEN
NSC FOR HUBBARD AND TONG

E.O. 12958: DECL: 4/11/2032
TAGS: EFIN ECON CH
SUBJECT: SHANGHAI'S FUTURE AS LEADING FINANCIAL CENTER

REF: A. SHANGHAI 159
¶B. SHANGHAI 174
¶C. SHANGHAI 133

CLASSIFIED BY: Kenneth Jarrett, Consul General, U.S. Consulate
General Shanghai, Department of State.
REASON: 1.4 (b), (d)

¶1. (C) Summary: During a March 23 meeting with the Consul General and Econoff, Shanghai Futures Exchange (SHFE) CEO Yang Maijun and Shanghai Office for Financial Services Deputy Director-General Fang Xinghai said Shanghai's role as China's leading financial center was secure; Hong Kong and Tianjin were not threats; and the May or June launch of the China Financial Futures Exchange (CFFE) should further solidify Shanghai's position. Fang was not optimistic about short-term prospects for reforms he had advocated in a March 6 Asia Wall Street Journal op-ed, including liberalization of China's Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs, and an ability to arbitrage the price difference on stocks listed on Mainland China and Hong Kong markets. He hoped that at least margin trading and the ability to take long and short positions would be allowed soon. Yang and Fang said Secretary Paulson's March 8 speech at SHFE (Ref A) was generally well-received by its audience of mostly Chinese financial sector officials and leaders of Chinese financial service companies because it identified the right course of action. However, it provoked a defensive nationalistic response by some who did not appreciate a foreign official telling China what it needed to do -- even if that official was right and it was in China's own interests. Fang said that to persuade China to undertake reforms at the upcoming Strategic Economic Dialogue (SED) meetings in May, the USG needed to be prepared to make concessions. He raised the licensing of PRC banks in the U.S. as one example. End summary.

Shanghai vs. Hong Kong: Not a Zero-Sum Game

¶2. (SBU) During a March 23 meeting with the CG and Econoff, Fang Xinghai , Deputy Director-General at Shanghai's Financial Services Office (and a former Executive VP at the Shanghai Stock Exchange) said that Shanghai did not face competition from Hong Kong, Beijing or even Tianjin, as China's financial center. Shanghai's role was well-established and secure given its infrastructure and human-resources capital. Fang said that a key part of his job was "developing Shanghai into a leading financial center;" the other key role was managing the Shanghai Government's investments in financial sector companies.

¶3. (C) According to Fang, Hong Kong and Shanghai's relationship should not be viewed as a zero-sum game. Just because Shanghai grew 10 percent did not mean that Hong Kong lost 10 percent. Tianjin was not a real contender as a financial center and "was only a player due to the mayor's background in financial circles." Beijing, despite having the regulators and major policy banks, was not a true threat to Shanghai in international terms. To support this argument, Fang pointed to the fact that despite heavy lobbying by Beijing's municipal government, only two foreign banks had opted to incorporate with Beijing as their headquarters.

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Shanghai Futures and China Financial Futures Exchanges
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¶4. (U) Shanghai Futures Exchange CEO Yang Maijun said that the SHFE was the biggest of China's three commodity futures exchanges and traded copper, aluminum, rubber and fuel oil. It had just launched trading of zinc that week since China was the world's top consumer. Yang said the SHFE had plans to list steel rods, gold, nickel and oil in the near future.

¶5. (SBU) Yang said that the China Financial Futures Exchange (CFFE), co-located with SHFE, should launch its first product in May or June. He believed that the development of CFFE had been fairly rapid since it was announced last August. He said that CFFE had clear political support, but that launching of trading had been delayed by technical issues and the development of trading processes. He reiterated that CFFE had worked very quickly to implement something as complicated as creating an entire market for trading financial futures.

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Need Long-Term View for Reforming China's Capital Markets
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¶6. (C) Fang was rather pessimistic about short-term prospects for reforms he had called for in a March 6 Op-Ed piece in the Asia Wall Street Journal (AWSJ) entitled "Taking Stock in China," including increasing QFII quotas, loosening QDII investment restrictions to increase demand, and devising a system to allow Chinese investors to arbitrage the differences in value of Chinese companies listed both in Hong Kong and Shanghai. (Note: Shanghai "A" shares sell at a P/E premium, compared to shares of the same company listed on the Hong Kong market, "H" shares. End note.) Fang was skeptical of his chances of influencing the policy debate in China, saying that he did not think that most Chinese decision makers read the English-language AWSJ. As a Chinese with extensive international experience (see bio note paragraph 12), Fang said one always needed to take the "long term view" to changes in China. He said that it often took several years for a policy proposal to become law. It was "good to talk about new ideas, but don't have any expectations of accomplishing anything quickly."

¶7. (C) Fang said that reforms the Shanghai Stock Exchange was planning (Ref B), such as changing the 10 percent daily limits on stock price movements and changing the settlement dates for stock purchases, were cosmetic and not necessary or important. What was needed, in addition to the more structural reforms he

had discussed in the AWSJ article, was the development of margin trading and mechanisms for investors to take both long and short positions on stocks.

¶8. (C) SHFE's Yang discounted rumors (Ref C) that average Chinese investors were mortgaging real estate holdings to fund stock purchases. Yang said that Chinese culturally found a great deal of security in owning a house and any attempt to try to borrow money against it to play the market was unlikely for the average investor. For "rich people," who owned more than one house, on the other hand, both Yang and Fang said that they knew of people who had mortgaged a second or third property to play the market. Fang reiterated that one of the problems with the market was that it was made up of too many retail investors, noting that increased QFII quotas would allow institutional investors to play a greater role in China's stock markets, thereby increasing stability.

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A Nationalist Reaction By Some to Paulson's Speech
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¶9. (C) Both Fang and Yang agreed with the fundamentals of Secretary Paulson's March 8 speech in identifying the right

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course of action and said Chinese financial leaders did as well. According to Fang, however, some Chinese officials questioned the tone of Secretary Paulson's remarks, noting that he had spoken "very directly" and "was telling us what to do." Yang and Fang agreed that Secretary Paulson had the credentials to give such a speech, but it had caused some in the audience to react in a "nationalistic" or defensive manner. Fang also critiqued the Secretary's assertion that he had "never seen a successful joint-venture securities firm" despite having been the head of the Goldman Sachs investment firm when it formed such a joint venture in China. (Note: Fang was referring to the Goldman Sachs-Gaohua joint venture. End note.) Fang said that

this critique was a "direct attack" on the Chinese model that had only allowed foreign securities firms to invest in China as joint ventures and would have been noted as such by Chinese financial leaders.

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SED: Just Because We Should Doesn't Mean We Will
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¶10. (C) Fang said that the U.S.-China Strategic Economic Dialogue (SED) was a useful forum for senior-level discussions. Regarding increased financial sector liberalization in China, he said that just because what the United States has asked China to do what was in China's own long-term interests did not mean that China would do it without concessions. The Chinese government had institutional issues it needed to overcome and domestic interest groups that were resistant to the reforms called for in the Secretary's speech. Furthermore, due to China's political calendar, Chinese officials would be unwilling to undertake any risky or controversial reforms until after the Party Congress in the fall.

¶11. (C) Fang added that the Chinese side would expect to receive concessions from the U.S. side for any concessions it made. He pointed out that at the same time the United States was pushing China for access to its market, no Chinese bank had been licensed to open in the United States and, after such deals as CNOOC had been blocked, China was feeling that its access to U.S. markets was increasingly fragile and certain parts had been closed off to Chinese investors and goods.

Bio Notes

¶12. (U) Fang Xinghai has a PhD in Economics from Stanford

University (1993) and a BS in engineering from Tsinghua University (1986). In 1993 he joined the World Bank's Young Professional Program as an economist/investment officer in Washington, DC. In 1998, he returned to China and worked at the China Construction Bank, China Galaxy Securities Company, and was Deputy Chief Executive Officer of the Shanghai Stock Exchange from 2001-2005. He became Deputy Director-General of the Shanghai Office for Financial Services in December 2005. He is married and speaks fluent English.

¶13. (U) Yang Maijun was born in 1955 in Dali, Yunnan Province. In the early 1970s, he worked on a farm in Yunnan Province for two years and then at a factory for three years. He was one of the successful applicants in the first round of college entrance examinations at the end of the Cultural Revolution. He was appointed General Manager and CEO of the Shanghai Futures Exchange in August 2006. Prior to joining SHFE, Dr. Yang was Director of the Futures Supervision Department at the China Securities Regulatory Commission. He is married. He understands more English than he speaks and is able to communicate on financial issues in English at a 3 level.
JARRETT